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In Search of Best Efforts: Reinterpreting Bloor V. Falstaff

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Abstract

Bloor v. Falstaff has become the standard casebook example of judicial interpretation of a "best efforts" clause. The court held that Falstaff's lackluster promotional efforts for Ballantine beer violated its "best efforts covenant, a result that has met with near universal approval. However, when the problem is properly framed, the decision is clearly wrong. The court's failure to consider the purpose of the transaction led it astray. Falstaff almost certainly did not breach its obligation.

The essential feature of the contract is that Ballantine was exiting the beer business and was making a one-shot sale of some of its assets to Falstaff. Ballantine wanted to receive the highest possible price and, other things equal, the fewer post-sale restrictions on Falstaff's exploitation of the assets, the more Falstaff would be willing to pay. So, any restriction, like the best efforts clause, immediately raises a red flag: how might the particular restriction raise the value of the Ballantine assets, ex ante? The deal included an "earnout" designed to cope with the information asymmetries inherent in the transaction. A significant part of Ballantine's compensation was in the form of a per barrel royalty. The role of the best efforts clause was to guard against the possibility that Falstaff could obtain the value from the Ballantine assets in a manner which bypassed the royalty. The poor performance of Ballantine beer post-acquisition was due not to Falstaff's diversion of revenue, but to the poor quality of the Ballantine assets (and the changing conditions in the beer industry).

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When contracting parties cannot quite define their obligations, they often resort to placeholder language, like "best efforts." They (and their counsel) likely have little idea of what they might mean, but, so long as they avoid litigation, it won't much matter. But "best efforts" clauses are on occasion litigated and courts must read content into them. In *Bloor v. Falstaff*, a casebook favorite,[1] the court held that Falstaff's lackluster promotional efforts for Ballantine beer violated its best efforts covenant. So far as I can tell, no commentators have questioned this outcome. Indeed, some commentators have found Falstaff's breach so egregious as to not provide much of a test of the boundaries of "best efforts." Farnsworth, for example, says: "Unfortunately, its decision did relatively little to add precision to the meaning of 'best efforts,' since Kalmanovitz [of Falstaff] fell so far short of the mark." [2] However, when the problem is properly framed, the decision is clearly wrong. Falstaff almost certainly did not breach its obligation.

The analysis is complicated by the poor drafting of the contract. "Best efforts" can only be defined contextually and here the context is a badly botched deal. If we look at the contract the parties should have written, it would be an easy case–indeed, it is unlikely that the "best efforts" language would have even appeared (at least not in the contested clause). In the actual agreement,

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[1]Bloor v. Falstaff Brewing Corp., 601 F.2d 609 (2d Cir. 1979). Casebooks which reprint it as a main case include STEVEN J. BURTON, PRINCIPLES OF CONTRACT LAW 448 (1995); JOHN D. CALAMARI ET AL., CASES AND PROBLEMS ON CONTRACTS 459 (2d ed. 1989); E. ALLAN FARNSWORTH & WILLIAM F. YOUNG, CASES AND MATERIALS ON CONTRACT 623 (5th ed. 1995); LON L. FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW 868 (6th ed. 1996); ROBERT W. HAMILTON ET AL., CASES AND MATERIALS ON CONTRACTS 254 (2d ed. 1992); ROBERT E. SCOTT & DOUGLAS L. LESLIE, CONTRACT LAW AND THEORY 280 (1988). The decision is briefly noted in the Knapp and Murray casebooks. CHARLES C. KNAPP & NATHAN M. CRYSTAL, PROBLEMS IN CONTRACT LAW: CASES AND MATERIALS 503 (3d ed. 1993); JOHN EDWARD MURRAY, JR., CONTRACTS, CASES AND MATERIALS 260 (4th ed. 1991). The case is cited in Murphy, but there is no further discussion. EDWARD J. MURPHY ET AL., STUDIES IN CONTRACT LAW 792 (5th ed. 1997).

[2]E. A. Farnsworth, On Trying to Keep One's Promises: the Duty of Best Efforts in Contract Law, University of Pittsburgh Law Review, 1, 10 (1984). "The opinion may seem somewhat disappointing in that the breach was sufficiently flagrant that the court did not define 'best efforts' with precision." E. A. Farnsworth and W. F. Young, Contracts: Cases and Materials—Fifth Edition, Manual For Teachers, pp. 186-7.

there are three plausible interpretations of best efforts. None is consistent with the interpretations forwarded by Judge Brieant at trial[3] and Judge Friendly on appeal.[4]

The essential feature of the contract is that Ballantine was exiting the beer business and was making a one-shot sale of some of its assets to Falstaff. Falstaff was not contracting to be a distributor for another beer producer, the remarks of numerous commentators notwithstanding.[5] The purpose of the contract–sale of an asset, not distribution of product–is crucial for understanding the role of this "best efforts" clause. The fact that some of Ballantine's compensation was contingent upon Falstaff's selling effort makes it appear similar to a distribution agreement. But the purpose of the contingent compensation is quite different and that should be taken into account when interpreting the contract. Thus, while I am sympathetic to the Goetz-Scott argument that the contract should be interpreted to maximize expected joint profits,[6] I disagree with their application of it to this case (which, in effect, treats the deal as if it were a distribution arrangement).

In Part I, I summarize the facts and the two opinions. In Part II, I explore the role of the contingent compensation in the sale of an asset and apply that analysis to the facts of *Bloor*.

I. The Background

A. The Facts

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[3]Bloor v. Falstaff Brewing Corporation, 454 F.Supp. 258 (S.D.N.Y 1978).

[4]Bloor v. Falstaff Brewing Corporation, 601 F.2d 609 (2d Cir. 1979).

[5]See, for example, J.C. Bruno, "Best Efforts" Defined, 71 Mich. B.J. 74, 76 (1992) ("Falstaff agreed to distribute Ballantine beer, in addition to its own label, in exchange for payments to Ballantine . . ."). Gillian K. Hadfield, Bias in the Evolution of Legal Rules, 80 Geo. L.J. 583, 608-9 ("The plaintiff signed a contract in which Falstaff, the defendant, agreed to use its 'best efforts' to promote the sale of Ballantine beer (which continued to be produced by Ballantine breweries)."). Lawrence S. Long, Best Efforts as Diligence Insurance: in Defense of "Profit Uber Alles," 86 Colum. L. Rev. 1728, 1733 (1986) ("Falstaff would not have agreed to spend money up front marketing Ballantine if Ballantine could later have come back and demanded a higher royalty . . ."). Robert E. Scott and Douglas Leslie casebook at 291 ("What changes do you think would be made in a new agreement between these two companies? Is that relationship likely to be renewed after litigation? Was litigation necessarily the best solution here?")

[6]Charles J. Goetz and Robert E. Scott, Principles of Relational Contracts, 67 Va. L. Rev. 1089 (1981).

Ballantine, a regional brewery selling low-priced beer primarily in the New York area, was sold to Investors Funding Corporation (IFC), a real estate firm, in 1969.[7] IFC lost a considerable amount of money with Ballantine, and left the beer business in 1972. It kept the brewery (eventually selling it for non-beer making purposes),[8] selling off the remainder of the business to Falstaff, a larger regional brewery that had no presence in the New York market. The parties had explored the deal for a few months but the final negotiations involved a marathon session of three days with no breaks for meals, characterized by one of the participants as "negotiation-by-endurance."[9] Falstaff paid

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[7]Unless otherwise noted, the facts are taken from the two published decisions cited above at notes 3 and 4. The record of the case is available on microfiche from the author; citations to the record will be limited to material not available in the public record.

[8]They attempted unsuccessfully, to convert the brewery into an industrial park. On October 21, 1974, IFC and its wholly-owned subsidiary IFC Collateral Corporation both filed for reorganization under Chapter X of the Bankruptcy Act. On November 1, 1974, James Bloor was appointed Trustee, replacing the Dansker management. On December 23, 1980, while other suits were still ongoing, Judge Bonsal approved a reorganization plan in which Helmsley Enterprises would inject new money. *See In re* Investors Funding Corp., 8 B.R. 739 (S.D.N.Y. 1980). Other litigation stemming from the IFC bankruptcy dragged on for over a decade. The Trustee Bloor had taken the position that a massive fraud had been perpetrated on the Company, and he sued the Danskers, the banks, the accountants, IFC's outside legal counsel, various others and, of course, Falstaff. The Trustee's claims against the principal accountants were dismissed. *See In re* Investors Funding Corp., 523 F. Supp. 533 (S.D.N.Y. 1980). Claims of the Trustee against the outside directors, IFC's outside legal counsel and various other individuals were also dismissed. *See In re* Investors Funding Corp., 566 F. Supp. 193 (S.D.N.Y. 1983), *aff'd sub nom*. Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 527 (2d Cir. 1985). Other claims of the Trustee against IFC's outside legal counsel were finally dismissed in 1986. *See In re* Investors Funding Corp., 635 F. Supp. 1262 (S.D.N.Y. 1986). In addition, holders of the stock and debentures of IFC filed five class actions against the Danskers, the accountants and the banks which were consolidated for trial. The securities holders settled with the banks and the accountants on March 17, 1981. *See In re* Investors Funding Corp., 9 B.R. 962 (S.D.N.Y. 1981). In an unrelated matter, some of IFC's officers faced criminal charges, stemming from the development of the George Washington Plaza shopping center. They were charged with conspiracy to give a $100,000 bribe to Burt Ross, the Mayor of Fort Lee, New Jersey. On March 28, 1975, former IFC officers Norman Dansker, Donald Orenstein and Stephen Haymes were convicted of bribery. *See* United States v. Dansker, 537 F.2d 40 (3d Cir. 1976), *cert. denied*, 429 U.S. 1038 (1977). They eventually served six months in jail. *See* Walter H. Waggoner, *Terms Cut for 4 in Ft. Lee Bribery*, N.Y. TIMES, February 4, 1978, at 1.

[9]Judge Brieant scolded the parties for their method, but acknowledged that "it was the manner chosen by the parties for their own purposes, and they must each accept the consequences. . . . They should", he said, "have conducted themselves in a more mature fashion. Had they done so, at least some of the later disputes and difficulties could have been anticipated

$4,000,000 plus a royalty of fifty cents per barrel for six years. Ballantine's sales in the IFC years were about 2.2 million barrels per year, well below the 1964 peak of 4.4 million barrels.[10] Had Falstaff maintained Ballantine's sales volume the royalty payment would have been over $1,000,000 per year. For acquisition purposes, the rule of thumb in the beer business at that time was to value the target at about $4 per barrel, which would have put a value on Ballantine of about $8.5-$9 million.[11] Falstaff agreed to use "best efforts" to promote and maintain a high volume of sales and further agreed to pay a cash sum in the event of a substantial discontinuance of distribution under the Ballantine brand name. The terms will be discussed in more detail below.

Falstaff's strategy was to enter the New York market, selling beer from its Cranston, Rhode Island brewery, under both the Ballantine and Falstaff labels. Falstaff was a premium beer, Ballantine a low price beer, although, in fact, the beer in the two containers was identical. Falstaff expected that buying the Ballantine assets would help it in three ways. First, Ballantine had a trademark that was potentially valuable, especially in the New York area. Second, it had an existing distribution network in the New York area (it was servicing some 25,000 accounts); Falstaff would not have to assemble one to sell Ballantine and could use that network to develop the market for Falstaff. Third, consolidating production in the Cranston facility and closing Ballantine's Newark brewery (which had been operating at less than fifty percent capacity, would increase capacity utilization rate, thereby decreasing average production costs.

The record is mixed as to the appropriate weighting of these components. In his letter to the Justice Department immediately following the acquisition, Falstaff's outside counsel described the purpose:

> You requested that I confirm Falstaff's purpose in acquiring the Ballantine brands and the steps which will be taken to produce and market Ballantine beer and ale. The primary purpose of the acquisition is to utilize the excess productive capacity of Falstaff's seven plants.
>
> * * *
>
> A further purpose of the acquisition (though not a major one) is that opportunity is afforded to introduce Falstaff beer on a premium price level in the New York metropolitan market. Any such introduction would necessarily be low-keyed, since Falstaff does not have the resources to support any other kind of entry into this market.[12]

A Falstaff internal document written at the very beginning of the process put much more weight on using the acquisition to facilitate Falstaff's entrance into the New York market:

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and avoided." (At 276, n. 11)

[10]PX 9 at A1618.

[11]Deposition of Falstaff's Ralph Weir, at A1576.

[12]PX23, A1677, A1678-9.

> Let us further assume that, since Ballantine is a declining brand, that Falstaff will not support and promote the brand, but, rather, cut advertising and promotion expenses to the bone and expect a rapid decline in sales of approximately 20% per year. Let us assume further that Falstaff uses the direct distribution system set up by Ballantine in the 5 boroughs and Northern New Jersey to promote Falstaff at a premium price. Since this is a large market, the market entry costs will be high. . . . In other words, the Ballantine distribution system will increase its distribution of Falstaff to offset the loss of volume for Ballantine such that the plants continue to produce at the capacity level the same as when Ballantine production was initiated.
>
> * * *
>
> Thus, under these assumptions, it does not seem worthwhile to purchase Ballantine except for the entry to the N.Y. markets.[13]

In any event, it did not work out. Falstaff continued to promote Ballantine at about the same level as IFC had, but sales kept falling and red ink spilling. Falstaff claimed losses in 1972-75 of $22 million on its Ballantine operations. In 1975, Paul Kalmanovitz acquired effective control of Falstaff and dramatically changed its operations.[14] In particular, he cut the Ballantine advertising budget nearly 90%, cut sales personnel, and closed or phased out four of the six distribution centers. Ballantine's sales plummeted. Some of the decline was attributable to the general sales decrease of regional beers, but Ballantine's sales fell faster than the sales of similarly situated beers.

In the meantime, IFC went into bankruptcy. Bloor, the trustee in bankruptcy for IFC, filed suit against Falstaff claiming, among other things, that Kalmanovitz's change of direction in 1975 violated Falstaff's best efforts obligation or, alternatively, amounted to a substantial discontinuance. There were some side issues related to the fact that some of Ballantine's pre-transaction sales volume was generated by illegal marketing practices, most of which were widespread in the industry, but the core of the dispute remained the best efforts and substantial discontinuance questions.

B. The Contract

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[13]Falstaff internal document entitled "Opportunistic Approach to Ballantine," PX 9, A1616, A1618-9 dated 9/1/71).

[14]Paul Kalmanovitz arrived in America penniless in his mid-20's and built a fortune in beer and real estate estimated at $250 million (enough to earn him a spot on the *Forbes* 400 list) at the time of his death in 1987. See Burt A. Folkart, "Paul Kalmanovitz, Beer Industry Magnate, Dies," *Los Angeles Times* January 23, 1987, p. 28. His treatment of Ballantine was consistent with his treatment of the other beer labels he acquired. "Kalmanovitz's reputation as a cost-cutter was so dreaded that employees at Falstaff Brewing's St. Louis headquarters flew the flag upside down and at half-mast when they learned that [he] had taken it over in 1975. 'He went through Falstaff like Grant went through Richmond -- he took no hostages,' recalls [his successor]." "Taking no hostages," *Forbes* May 22, 1995.

Falstaff purchased the "Ballantine Assets" which were defined in the contract.[15] These included (a) the "Proprietary Rights," Ballantine's brand names, trademarks, trade names, and copyrights; (b) Ballantine's distribution network, including contracts, orders agreements, commitments, supply and requirements contracts, and collective bargaining agreements relating to the sale and delivery of its malt alcoholic beverage directly to retail sellers; (c) most of Ballantine's accounts receivable, roughly $9 million; and (d) miscellaneous items including the existing inventory and supplies, vehicles, cooperage, returnable cases and bottles and similar items. Falstaff paid $4 million cash in three installments, the last payment on the date of closing. In addition, Falstaff would pay a royalty of $.50 per barrel:

> 2 (a)(v) on the 7th day of each month, commencing May 7, 1972, and terminating April 7, 1978 (the "Royalty Period"), a sum in cash computed at the rate of $.50 per barrel for each barrel of 31 U. S. gallons sold by the Buyer during the preceding calendar month *under any of the Proprietary Rights, as royalties in respect of the use of such Proprietary Rights.* (Emphasis added)

The italicized clause was omitted in both opinions. As we shall see below, the clause is significant for interpreting the agreement.

That clause included a liquidated damages clause that would have come into effect if Falstaff substantially discontinued distribution of Ballantine.

> provided, however, that if during the Royalty Period the Buyer substantially discontinues the distribution of beer under the brand name "Ballantine" . . . , it will pay to the Seller a cash sum equal to the years and fraction thereof remaining in the Royalty Period times $1,100,000, payable in equal monthly installments on the first day of each month commencing with the first month following the month in which such discontinuation occurs. . . .

The clause at the center of the litigation, which included a rather embarrassing typographical error, read as follows: "8. Certain Other Covenants of Buyer. (a) After the Closing Date the Seller [sic!] will use its best efforts to promote and maintain a high volume of sales *under the Proprietary Rights*." (Emphasis added)

This was not the only appearance of "best efforts" in the agreement. It appears six other times. Falstaff agrees to use its best efforts to keep confidential non-public information about the seller.[16] The seller agrees that if any of its contracts are not assignable, it will use its best efforts to obtain consent of third parties.[17] Falstaff agrees to use its best efforts to collect the seller's

[15]Clause 1 of the contract. The complete contract is available as PX-1 at pages A1584-A1616. In each instance Falstaff would acquire Ballantine's "right, title, and interest," with the specific items defined in separate exhibits.

[16]Clause 4.

[17]Clause 6(a).

receivables (a contractually defined subset of the receivables).[18] The buyer also promises to use best efforts to collect the *buyer's* receivables.[19] This is not as odd as it first appears, since the seller has some financial stake in the buyer's receivables. Falstaff also agrees to use best efforts to retain as its own employees Ballantine's sales, marketing, clerical, and administrative personnel.[20] The casual usage of the phrase in these varied contexts does suggest a certain lack of care about its content.

At the closing Falstaff was to pay cash for 75% of Ballantine's receivables.[21] In addition, it would pay to IFC 75% of all receivables collected beyond that, subject to a ceiling of $7,125,000.[22] There was some concern over the receivables since in Pennsylvania it was unlawful for beer to be sold on credit and at least one large receivable (Pflaumer) was from Pennsylvania.[23] The treatment of receivables, as we shall see, turned out to have some significance, since IFC claimed (and Judge Brieant agreed) that Falstaff's payment for the receivables was part of the horse trading involving the critical terms in the contract.

The contract included what amounts to an acceleration clause, requiring Falstaff to pay immediately all money due under the royalty clause in the event of its bankruptcy.[24] The language is unclear, but I believe the clause means that the $1.1 million per year liquidated damages would be due, not the uncertain expected value of the sum of future royalty payments. Falstaff also agreed to pledge to IFC the proprietary rights (the trademarks) as security for the royalty payments. If, however, such a pledge would be in violation of any of Falstaff's pre-existing agreements, Falstaff will "in good faith attempt to obtain . . . any consents to such pledge which may be required; and if any required consent is unobtainable or obtainable only upon conditions detrimental to [Falstaff], such pledge will not be deliverable as aforesaid. In such event, [Falstaff] will furnish [IFC] with such

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[18]Clause 6(b). The phrase is used twice in this context.

[19]Clause 8(g).

[20]Clause 8(d).

[21]Clause 2 (a)(vi).

[22]Clause 2(a)(vii) and clause 2(b).

[23]Discussed in the lower court decision at 274; At the time of closing Pflaumer owed over $800,000.

[24]Clause 2(d). "If the Buyer shall . . . file a voluntary petition in bankruptcy . . . [or other bankruptcy and insolvency related conditions] then each of the payments or installments provided for in subparagraph (v) of paragraph (a) above shall immediately become forthwith due and payable without demand or other notice of any kind."

evidence as it may reasonably request to ascertain the reasons therefor."[25] Falstaff agreed not to transfer the proprietary rights during the royalty period without IFC's written consent.[26]

C. The Decisions

Trial was held without a jury. Falstaff argued that best efforts "must include considerations of Falstaff's own allegedly precarious financial position. Plaintiff, on the contrary, cited substantial precedent holding that financial difficulty and economic hardship do not excuse performance of a contract, and argued for the application of an objective standard, that of the 'average, prudent comparable' brewer."[27] Judge Brieant cited with approval precedent which would not excuse performance even in the face of financial difficulty or economic hardship.[28] But he did not go this far. Falstaff did not have to spend itself into bankruptcy to meet its contractual obligation, but it did have to meet the prudent comparable brewer standard, "and this it failed to do."[29]

Judge Brieant presented a litany of things Falstaff did (or failed to do) in failing to meet its best efforts obligation. He cited Falstaff's closing of four of its retail distribution centers, including the North Bergen facility, which, he said, had been losing about $2.2 million annually distributing Falstaff and Ballantine products.[30] He criticized Falstaff's shifting from a distribution system which sold to a large number of retail accounts to one selling to a small number of wholesale accounts, in particular the assignment of the New York market to a particular distributor (Fatato) and Falstaff's failure to accept a different one (Molyneux).[31] The judge also criticized Falstaff's severe "cutback of

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[25]Clause 8(b). I suspect that nothing was intended by the use of "good faith" here as opposed to "best efforts" which is scattered through the remainder of the document (including three of the seven covenants of the buyer in clause 8).

[26]Clause 8(e).

[27]At 266.

[28]Insolvency or bankruptcy does not excuse performance of a contract. While the point is correct, it would take a large leap of logic to apply it to interpretation of the best efforts language.

[29]At 267.

[30]At 267.

[31]"In any event, after May 1976, any inability to appoint such an exclusive distributor in the New York area was caused by the fault or negligence of Falstaff. To the extent such fault or negligence prevented it from using effective marketing methods in the area which Molyneux proposed to serve, it is answerable in damages to Ballantine.

* * *

"Mr. Kalmanovitz as a traditional businessman expressed at trial his contempt for 'studies"' and 'projections.' Consequently, in making the decisions to close the North Bergen personnel in distribution, sales, marketing, administrative and warehousing areas. It virtually eliminated its promotion and advertising of Ballantine Beer and closed its advertising department."[32] He quoted, and implicitly criticized, Kalmanovitz's description of his marketing strategy:

> We sell beer and you pay for it. . . . We sell beer, F. O. B. the brewery. You come and get it.
>
> Our responsibility is to give good product and you got responsibility to pay for it. That's it. That's the substance of my arrangement. Its working.[33]

Falstaff had not, he held, treated Ballantine equally. Even if they had, he argued, that would not be enough.

> Falstaff's relationship to Ballantine is essentially different from its relationship to its own products. In the latter case, it may promote, continue or discontinue its products as it wills, subject to its duty to shareholders; in the former case it is bound by a contractual duty to the promisee. As the court said in a case cited by the defendant here: "'(B)est energies' meant such effort as in the exercise of sound judgment would be likely to produce the most profitable results to the promisee in view of the nature of the business and the extent of the territory over which it was to be conducted." Randall v. Peerless Motor Car Co., 212 Mass. 352, 374, 99 N.E. 221, 226 (1912).[34]

Moreover, he suggested, Falstaff's incentives favored promoting Falstaff at the expense of Ballantine.

> Some of this apparent callousness towards Ballantine sales is undoubtedly caused by the fact that even though the liquid in a can of Ballantine Beer and in a can of Falstaff Beer is identical, and accordingly costs exactly the same amount to produce, sale of Falstaff Beer produces a greater profit for Falstaff. In part this is the result of the fact

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facility and to appoint Mr. Fatato distributor in the New York City area, no effort was made to ascertain in advance the effect on Ballantine sales. . . . Falstaff was willing to appoint a distributor for the area, Mr. Fatato, about whose abilities the President of Falstaff had serious reservations, and to continue him in a virtual monopoly of Falstaff products in the area despite Mr. Molyneux's proposals. These actions exceed any reasonable variance allowable in the exercise of sound business judgment. No effort was made by Falstaff to examine or find alternatives to the drastic step of closing the North Bergen facility, although it accounted for a very large percentage of Ballantine sales." (At 269)

[32]At 270. Note that if this violated the best efforts obligation to sell Ballantine it likely would have also violated the best efforts obligation to keep employed the Ballantine personnel; see text at note 20 above.

[33]At 270.

[34]At 270-71.

> that Falstaff is a "premium" beer and nets Falstaff about $4.20 more a barrel than does Ballantine, even before the $.50 Ballantine royalty is subtracted from the latter.[35]

Judge Brieant rejected the claim that Falstaff's behavior amounted to substantial discontinuance of Ballantine. Falstaff had continued to distribute beer under the Ballantine name and had introduced Ballantine in other markets. Ballantine's sales had dropped dramatically. However,

> [a] very significant part of this decline is attributable . . . to the general decline of the market share of the smaller brewers, and to other causes unconnected with Falstaff's closing of the North Bergen facility. The remaining decline is regarded as "insubstantial" under the contract. It is clear from the royalty rate established in the contract itself that the liquidated damages clause was included to cover situations approaching the total cessation of Ballantine production, rather than situations involving gradual but significant declines in sales.[36]

Damages were calculated by subtracting Ballantine's actual sales from the sales that would have been made had Falstaff used its best efforts (as determined by the court). The judge assumed that Ballantine's sales would have followed the same trend as two other small New York labels, Schaefer and Rheingold. After some modest deductions, primarily to exclude Ballantine sales that were the product of illegal activities, the judge concluded that the royalties lost by Ballantine were approximately $630,000. Falstaff had withheld royalties during the litigation and these too were awarded bringing the final judgement to about $1.3 million.

Falstaff appealed the best efforts ruling and Bloor the rejection of the substantial discontinuance claim. Judge Friendly, speaking for a unanimous court, affirmed. He restated Judge Brieant's conclusion, softening it a bit. Brieant's decision might have been interpreted as requiring Falstaff to continue promoting Ballantine regardless of the financial consequences. Friendly made clear, however, that "best efforts" did not mean that Falstaff must go to these lengths. But it did have a special duty to promote Ballantine beer sales.

> While [the best efforts] clause clearly required Falstaff to treat the Ballantine brands as well as its own, it does not follow that it required no more. With respect to its own brands, management was entirely free to exercise its business judgment as to how to maximize profit even if this meant serious loss in volume. Because of the obligation it had assumed under the sales contract, its situation with respect to the Ballantine brands was quite different. The royalty of $.50 a barrel on sales was an essential part of the purchase price. Even without the best efforts clause Falstaff would have been bound to make a good faith effort to see that substantial sales of Ballantine products were made, unless it discontinued under clause 2(a)(v) with consequent liability for liquidated damages. . . . Clause 8 imposed an added obligation to use "best efforts to promote and maintain a high volume of sales. . . ." (emphasis supplied). Although

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[35] At 269-70.

[36] At 266.

> we agree that even this did not require Falstaff to spend itself into bankruptcy to promote the sales of Ballantine products, it did prevent the application to them of Kalmanovitz' philosophy of emphasizing profit uber alles without fair consideration of the effect on Ballantine volume. Plaintiff was not obliged to show just what steps Falstaff could reasonably have taken to maintain a high volume for Ballantine products. It was sufficient to show that Falstaff simply didn't care about Ballantine's volume and was content to allow this to plummet so long as that course was best for Falstaff's overall profit picture, an inference which the judge permissibly drew. The burden then shifted to Falstaff to prove there was nothing significant it could have done to promote Ballantine sales that would not have been financially disastrous.[37]

II. The Deal

Conspicuous by its absence in both decisions is any analysis of why the contract included the royalty arrangement and the best efforts covenant. This is not the fault of the judges. The record was completely silent on this point. So, we are left with the somewhat peculiar spectacle of a court giving meaning to a context-sensitive phrase with no guidance as to the context. The picture is clouded by the fact that the parties themselves probably did not really understand the function of the royalty. I will first provide the context the court lacked. Then, after showing that the context dictates how best efforts should be interpreted, I will consider how the parties understanding, or lack thereof, should influence the decision.

IFC was, essentially, selling two assets—Ballantine's brand name and its distribution network. Its purpose was simple. It wanted to sell at the highest price. That should be obvious, but the court's failure to recognize this basic point is the core of the problem. Other things equal, the fewer post-sale restrictions on Falstaff's exploitation of the assets, the more Falstaff would be willing to pay. Falstaff's pursuit of "profit uber alles," ex post, redounds to IFC's benefit, ex ante. So, any restriction, like the best efforts clause, immediately raises a red flag: how might the particular restriction raise the value of the Ballantine assets, ex ante?

A. Contingent Compensation

Falstaff could have purchased the Ballantine assets outright rather than spreading the compensation over six years and making the payment contingent upon Ballantine sales. Why did they choose the latter course? Ballantine was, in effect, making a six year loan to Falstaff. The security arrangements and acceleration clause discussed above[38] are manifestations of this. A loan would make sense only if Falstaff could get terms at least as favorable from IFC as from alternative

[37] At 614-5.

[38] See text at notes 24 and 25.

sources.[39] If restrictions in its existing capital structure—debt covenants and the like—constrained Falstaff, spreading the payments over time might have been a simple way of financing the transaction without violating the constraints.[40] A Falstaff planning document entitled "Ballantine Observations" hinted at some of the financing considerations:

> 4. Falstaff's financing of this purchase —What form would it take—would it take external financing, stock issue, additional long-term debt, what is the availability of any of the forms of financing and what would it cost and what restrictions would it place upon our operations.
>
> 5. The present debt agreements
>
> a. Do they allow this type of acquisition and when must these insurance companies be notified that we are considering such action.
>
> 6. The stockholder approval—What would be the mechanics here—what is the timing of such notification and what are the consequences of our announcing such to the stockholders in light of our present earnings situation and that of the last few years.[41]

While spreading the payments over time might be a perfectly sensible way to finance the project, financing considerations cannot explain why the payments were contingent upon Ballantine sales. Something more is necessary to explain why IFC in its role as financier would choose to take neither a fixed return nor an equity position in Falstaff.

One explanation, which cannot work in this context, would be that Ballantine's managers were providing a bond to Falstaff to assure that they would not by their future actions reduce the value of the Ballantine trademark. Suppose that the top management of Ballantine had developed some good will with the beer market. The value of the brand name they were selling would be impaired if they could subsequently reenter and compete against Ballantine. A promise not to compete would, if enforceable, make the Ballantine assets more valuable. Giving these managers an interest in Ballantine's future sales or profits could substitute for, or complement, the non-compete covenant.[42] The problem with this explanation, of course, is that the outgoing Ballantine executives

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[39]If the costs of litigation are high, spreading the payments over time would give Falstaff some leverage to bargain down its future obligations. Deferral changes the status quo for subsequent litigation.

[40]It is always possible that the structure of a transaction reflects tax consequences; I do not know of any in this instance and the record gave no indication of any.

[41]PX 14, dated Jan 8, 1972, A1624 at A1625.

[42]Such arrangements, called "earnouts," are common in sales of corporate assets.

had no competence in the beer industry[43] or expectation of staying in the beer industry and Falstaff knew it. A promise not to compete, or any variant thereon, would have been worthless.

The one explanation that does make sense, regardless of whether Falstaff wanted (or needed) financing assistance from IFC, is that the parties had asymmetric information. Ballantine was certifying the quality of the assets. In sales of complex assets the seller typically has more information than the prospective buyer.[44] If buyers cannot distinguish good assets from bad, then they are likely to be suspicious of any particular asset and to reduce their offer price accordingly. Sellers can get a better price if they can convince buyers of the quality of the asset. There are myriad ways of providing assurance.[45] The seller can provide extensive representations and warranties; the buyer can engage in extensive due diligence investigation. The parties have an incentive to economize on the joint production of information. By accepting some of its compensation in a contingent form, the seller provides some assurance to the buyer of the quality of the asset.[46]

1. The Proprietary Rights. The contract language, read literally, linked the royalty payment to the proprietary rights alone.[47] That might be one more manifestation of bad drafting, but for the

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> [43]Judge Brieant accurately characterized IFC's competence in the beer business: Mr. Donald Orenstein was Executive Vice-President of Investors Funding Corporation and of P. Ballantine & Sons at the time the negotiations with Falstaff took place. He testified at trial to the IFC management's complete lack of experience in the brewing industry. His own career began with IFC as a clerk, and ultimately he became President of IFC Realty Service. He stated at trial his views on IFC's acquisition of Ballantine (Tr. p. 124): "Q. When did it become apparent to you that Investors Funding should sell P. Ballantine & Company? A. The second day that I arrived at P. Ballantine, in '69. He (Mr. Jerome Dansker, Chairman of the Board of IFC) bought it on a Thursday; I told him Friday to sell it." (At 263, n. 6)

[44]See Victor P. Goldberg, The Gold Ring Problem, 47 *University of Toronto L.J.* 469 (1997) which also analyzes the case in which the buyer might have superior information. Ballantine had superior information about the quality of its assets, but Falstaff had superior information about its plans on how to use those assets. Contingent compensation allows the seller to capture some of the gains despite its relative ignorance about the buyer's plans.

[45]See Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 *Yale L. J.* 239, 262-4.

[46]An earnout is a way of bridging the difference in evaluations and conveying the seller's confidence in the quality. See Gilson (note 45) at 262-7; Goldberg, The Net Profits Puzzle,97 *Columbia Law Review* 524, 544-6; and Goldberg, *Gold Ring* (note 44) at 494.

[47]See text at note 15.

moment let us assume that was what the parties intended. How should the best efforts language be interpreted? Falstaff purchased the proprietary rights in order to exploit them efficiently. By maintaining the flexibility to respond to new information as it appears, Falstaff increases the amount it would be willing to pay Ballantine for the right to exploit the brand name. Judge Brieant, recall, suggested that Falstaff's "callousness towards Ballantine sales" was evidence of Falstaff's failure to use best efforts.[48] But, as Falstaff's CEO at the time of the transaction, Robert Colson, testified: "The intention when we went into this deal was to use our best efforts, and that's exactly what it says there. We were going to go out and do our best efforts to promote the brand, or why would we have bought the brand? You don't buy something with the intention that you're going to abandon it. If you did, then you spend a lot of time wasting your time."[49] "Best efforts," in this interpretation, is little more than filler. It means nothing more than "Aw shucks, we'll really try," as it did when defining Falstaff's obligation to try not to fire Ballantine's low level personnel.[50]

This argument has to be modified slightly because the royalty arrangement distorts Falstaff's incentives. The parties want an arrangement which maximizes the value to the buyer ex ante. But producing information and assurance is not costless. The process of maximizing the value of the asset can reduce the size of the joint pie. The particular method chosen here, the royalty, has an adverse effect by changing Falstaff's incentives ex post. And knowledge of this effect should reduce the value of the assets ex ante. The royalty acts as a tax (roughly 2%)[51] on sales which could induce Falstaff to market a somewhat smaller amount of Ballantine product than it would have, but for the royalty. So "best efforts" might possibly mean that Falstaff should push its sales effort a bit beyond the point that would otherwise be optimal, ex post. This is, I think, a bit of a stretch, but this would seem to be the outer limits of the "best efforts" concept if it applied only to the proprietary rights. The distortion of incentives (which in this instance is quite minor) is a common problem in contingent compensation arrangements (franchise fees, percentage leases, oil and gas royalties, and so forth) and "best efforts" is just one of the devices for dealing with the problem.

2. The Distribution Network. Suppose instead that the contract language was not restricted to the proprietary rights, but that "best efforts" applied as well to the collection of contracts and informal relations that together made up Ballantine's distribution network. Falstaff was, after all, attempting to break into the New York market to sell its own brand and Ballantine's owners were

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[48]See text at note 35.

[49]At A1099.

[50]See text at note 20.

[51]Ballantine's 1970 price was $26.60 per barrel (PX 9 at 1618) and the royalty rate was 50 cents per barrel.

aware of this prospect.[52] Suppose, to take an extreme example, that the proprietary rights were in fact worthless, but that the value was in the distribution network. Had Falstaff simply jettisoned the Ballantine brand entirely and used the distribution network to distribute Falstaff beer instead, Falstaff would not simply be *maximizing* the value of the asset (the distribution network)—it would be *diverting* payment for that asset. The royalty arrangement would fail completely in its purpose.[53] More generally, to the extent that Falstaff could use the distribution network to sell Falstaff rather than Ballantine, the royalty would not track the value of the asset. Judge Brieant's concern about Falstaff's "callousness" would be relevant under this interpretation of the contract.

A "best efforts" requirement is one contractual device for protecting against this sort of diversion. But the context suggests how the clause should be read. "Best efforts" in this context means that Falstaff agreed that in its pursuit of "profit uber alles" it would not opportunistically divert sales from Ballantine (the sales of which were to track asset value) to Falstaff. Did Falstaff use the network to divert more sales than the parties should reasonably have expected? That might be a difficult question to answer for some fact patterns, but for the facts of this case the answer is easy and negative. When Kalmanovitz took charge he dismantled the distribution system. Falstaff did not divert resources to the more profitable brand, it simply terminated (or at least drastically pared) a project that did not work.

So, we are left with three plausible meanings of "best efforts" in the context of this transaction. First, it could just be noise with no effect at all on Falstaff's obligation. Second, it could be aimed at correcting Falstaff's incentives which were a bit distorted by the royalty "tax." Third, and the contract language notwithstanding, the most plausible, it could have been an attempt to limit diversion of revenue away from the device chosen to provide assurance of that value. None of these provides a basis for concluding that Falstaff's pursuit of profit uber alles by revising its Ballantine marketing strategy and dismantling much of the Ballantine distribution network violated its obligation to Ballantine.

This is a simple and, I believe, compelling story. There is only one problem with it. It is not the story told by the witnesses or counsel. That does not make it wrong. But it does raise the questions of how courts are supposed to figure it out and, if they do, what they should do about it.

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[52]On Falstaff's interest in the distribution network, see text at note 13. On Ballantine's awareness, see the testimony of Melvin Carro, of Falstaff: "There was an expression of concern stated by somebody on the Ballantine side that possibly Falstaff would use the Ballantine distribution system to come into the New York area, and then for reasons of its own, it might be possible . . . that Falstaff would concentrate on the sales of Falstaff, and either abandon or let the Ballantine beer sales diminish." (A1074-5)

[53]For completeness, we can identify another diversion possibility. Instead of selling Ballantine beer under the proprietary rights, Falstaff might have sold Ballantine pretzels or clothing or some other non-beer trademarked articles. They didn't, so I need not pursue the matter further here.

That problem is compounded by the "substantial discontinuance" proviso which can be explained, but the explanation is neither so simple nor compelling. After attempting to make some sense of the proviso, I will return to the problem of decision-making by an ill-informed court.

B. Substantial Discontinuance

It is common to couple royalty payment schemes with minimum payment obligations. Such arrangements are common in publishing and movies (talent receive royalties or a percentage of the gross to be offset against a bargained for fixed fee),[54] licensing agreements, franchising, shopping center and other retail leases, and so forth. It is tempting to assume that such arrangements would make sense in the sale of an asset, as in the present case. Indeed, my initial presumption was that the "substantial discontinuance" clause was a poorly drafted attempt to create a minimum obligation. However, I was wrong. The minimum does not add anything useful for the sale of an asset where the seller, like Ballantine, has no interest in, or affect upon, the outcomes other than the receipt of its compensation.

Consider first the proprietary rights. Up to the minimum, the effective tax rate is zero. Incentives still are distorted at the margin, but a high minimum means that at least over a broad range, the buyer's incentives are not distorted. But the higher the minimum, the weaker the quality assurance provided by the royalty. A high minimum undercuts the quality assurance function since the purchaser must pay regardless of quality. So, while a minimum annual payment might help correct the tax distortion of the per barrel royalty, it does so only by undercutting the purpose.

A minimum guarantee might conceivably be of a bit more use in policing diversion. If the parties were indeed concerned with the possibility that Falstaff would use the Ballantine distribution network to distribute Falstaff beer, a minimum obligation would have imposed a sharp limit on Falstaff's ability to do so. But if the advantage of distributing Falstaff were substantial (recall Judge Brieant's claim that in addition to the 50 cent per barrel royalty, the identical beer sold for $4.50 more per barrel when labeled Falstaff),[55] then Falstaff would have had a strong incentive to treat the minimum as a target. The royalty would serve no particular function.

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[54]On publishing contracts, see Yoram Barzel, Measurement Cost and the Organization of Markets, 25 *J. of Law & Economics* 27, 34 (1982) and Henry Hansmann and Renier Kraakman Hands-Tying Contracts: Book Publishing, Venture Capital Financing, and Secured Debt, 8 *J. of Law, Econ. & Org.* 628 (1992). On gross profits compensation in movies, see Goldberg (*Net Profits*) note 46, at 547-8.

[55]A price differential of around 20% is not trivial. However, we should recognize that brewers engage in a form of (legal) price discrimination by targeting different groups with beers priced accordingly. There is no reason to believe that Falstaff could sell its brand to the "price beer" market reached by the Ballantine brand and maintain the price differential.

Ballantine asked for a minimum guarantee, but Falstaff refused. Ballantine's Orenstein testified:

> Falstaff was never willing to give us a guarantee of a million one. They said they would use their best efforts . . . they didn't give us really, what we wanted. We wanted a million one guarantee, that if for any reason the sales dropped below fifty cents a barrel times two million two . . . we would be guaranteed at least, a million one, and that's not in the contract.
>
> Q. It did not get in there?
>
> A. No. We traded that off. It did not get in there.[56]

Although the contract did not include a minimum guarantee, it did include liquidated damages of $1.1 million per year (the same amount Ballantine had been asking as the minimum) in the event of Falstaff's substantial discontinuance of Ballantine. If this proviso was included as part of the quality assurance mechanism, as I first thought, it makes no sense. In effect, it says: if the assets are really terrible so that they are unusable, then Falstaff pays Ballantine $1.1 million per year for the duration; if on the other hand, they are only pretty bad, Falstaff pays less. That is a perverse result, which I thought, could only be explained by poor drafting.

However, the clause makes more sense if it is viewed as being independent of the quality of the proprietary rights and instead concerns diversion of revenues from the exploitation of Ballantine's distribution network. That might be a somewhat heroic reading, given that the contract language refers to compensation for the proprietary rights. With this reading Falstaff says, in effect: We agree that we will not cheat you by diverting receipts from the metering device (Ballantine sales) and profiting by the use of the other valuable asset we have purchased, your distribution network; if we have done too much diversion, we agree to pay a penalty (although the law does not permit us to call it that).[57] The trigger for the penalty would not be the quantity of Ballantine sold nationally. Rather, it would be the percentage of Ballantine being sold through the old Ballantine network.

But this mechanism had one big hole. What if the network itself turned out to be of little or no value, as was in fact the case? Falstaff essentially abandoned the network, but continued to exploit the proprietary rights as best it could. If the proviso's purpose was to thwart massive diversion of

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[56]Orenstein deposition at A1465-66. Falstaff's attorney made the same point:

> During the negotiations, P. Ballantine & Sons attempted to elicit from Falstaff a guarantee as to the minimum royalty that would be paid to Ballantine, and Falstaff staunchly resisted any effort to force a minimum payment of royalties, and so the contract read that there would be only best efforts required of Falstaff Brewing Corporation. (At A60)

[57]Falstaff's Reply Brief raised, somewhat half-heartedly, the possibility that the proviso might be a penalty clause: "[A] construction of the proviso that would give it effect in any circumstances other than the near total cessation of Ballantine production would make of it, not a liquidated damages provision, but an unenforceable penalty clause." (p. 37)

revenues, there was no diversion. Falstaff bore the direct risk of the distribution network being a lemon; it seems unlikely that ex ante the parties would have wanted Falstaff to post an additional bond against that prospect. But, and this must be emphasized, it is most likely that neither party expected the distribution network to be worth so little, and the contract reflected their failure to anticipate this possibility.

C. So, What's a Poor Court to Do?

The parties did not give the court much assistance in framing the case. This is, I believe, less a matter of the peculiar way in which facts percolate up through the judicial system than of genuine confusion. Orenstein's testimony on the origins of the controversial terms is indicative:

> In substance what happened is that we just couldn't get together on those three items. It was the accounts receivables, the best efforts, and . . . the words substantial discontinuance. What does that really mean? How does one determine that? Can't we put in a formula? No, we won't give you a formula; we don't want to attach ourselves to anything. That's Colson's exact words. We told him, How can we make a deal not knowing where we're going? He said, Well, you have to believe that we're experts in the beer business for so many years; you're not selling to us just to collect a million one, you're going to look to us to collect much more, and we'll be able to increase the sales.
>
> I said, Well, if that's the way you feel, why don't you write it? He said, No, he's not prepared to do that. They have certain standards under which they do deals, and that's one of them. They didn't want to put it in writing, but that's how we came to the receivable. I said, If that's the feeling, give me something. Take my receivables. He said, Maybe we'll do that. That's how the next dialogue started. They then recessed. . . .
>
> I told [my colleagues] that the substantial discontinuance thing bothers me. What does that mean? Should we put in a percentage? Do you think we should try for a percentage? Then we all collectively said, in our minds, 30 percent would be considered a substantial discontinuance. I went back and mentioned that figure and they laughed. There was no way they would do it.[58]

Ballantine's lawyers asked various witnesses what best efforts meant to them and whether it meant more than good faith, a sterile inquiry designed to wrench damning statements out of the mouths of unwary witnesses. But neither side ever framed the question in terms of the underlying purpose of the transaction: sale of an asset of uncertain value. The courts accepted the parties' terms of debate.

This was not inevitable. A court with a confident understanding of what the deal was about could easily have framed the best efforts question properly and disposed of it cleanly. From the

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[58] At A1473-4.

contractual context, the plausible meanings of best efforts were narrowly circumscribed and under all of those meanings, Falstaff had satisfied its obligation.

The substantial discontinuance proviso was another matter. The most plausible explanation concerns the diversion of the revenue from the Ballantine distribution network, but the proviso is included in a clause concerning compensation for the proprietary rights. Worse, while this might be the most plausible explanation, it is not entirely convincing. Worse yet, the contract language failed to anticipate the central problem in the case: the Ballantine distribution network turned out to be a disappointment. Given the purpose of the transaction, we might reasonably infer that shutting down that network completely would not constitute a substantial discontinuance. But that interpretation sits poorly with the contract language and the evidence adduced. It would take a very confident court, indeed, to impose this meaning on the clause. The court probably ended up at the right result regarding the proviso despite the contract's lack of guidance as to how to get there.

III. Concluding Remarks

Generally speaking, giving content to an amorphous concept like "best efforts" is extremely difficult. Even in this contract, in which "best efforts" was invoked seven times and "good faith" once, it is hard to determine how a court should respond to claims that particular best efforts obligations were not met. How, for example, should one deal with a complaint that Falstaff had failed to meet its best efforts obligation to maintain as its own employees Ballantine's sales, marketing, clerical and administrative personnel? Ironically, while the problem is generally difficult or intractible, in the one case that has filtered down to the casebook level, the problem turns out to be an easy one. The context—a one-shot sale of assets—delimits the feasible meanings of "best efforts" and all of the meanings lead to the same conclusion: the courts got it wrong.